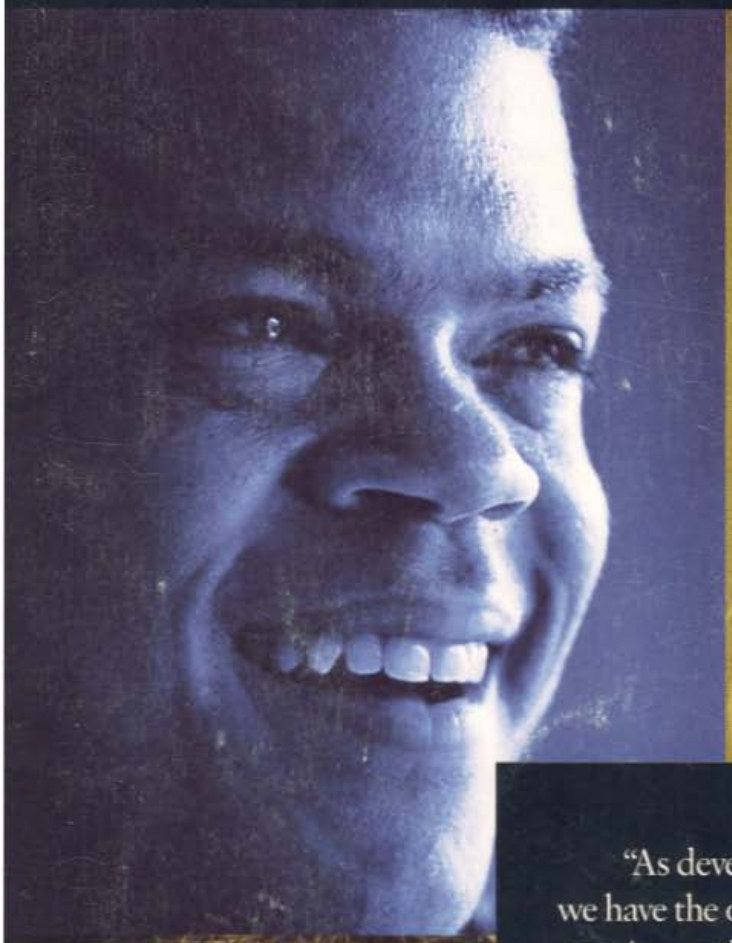
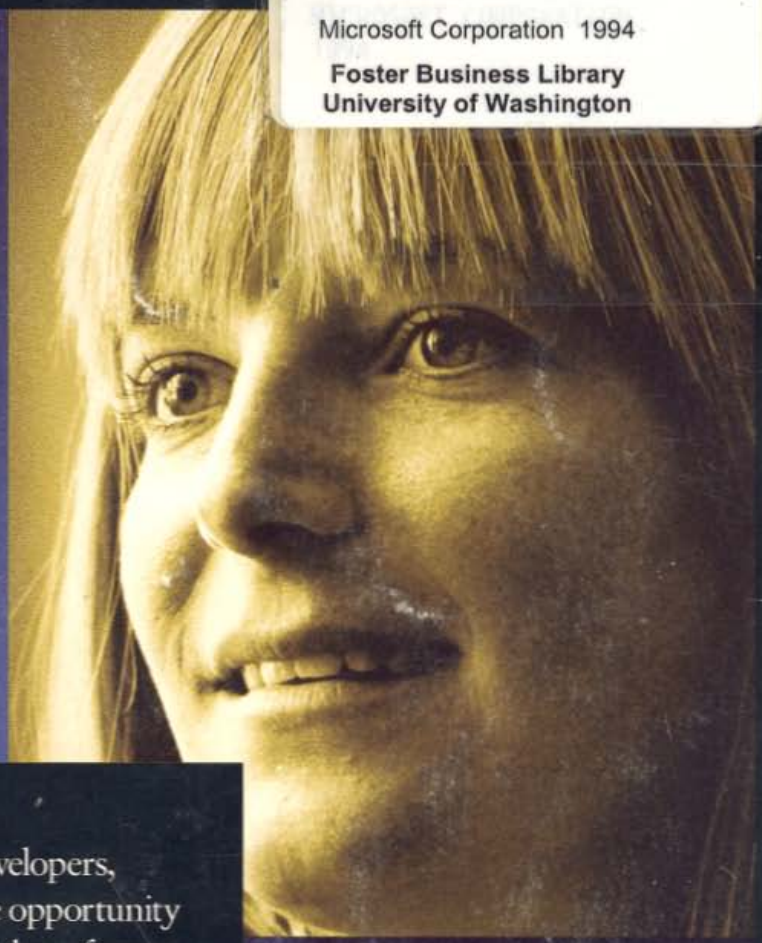
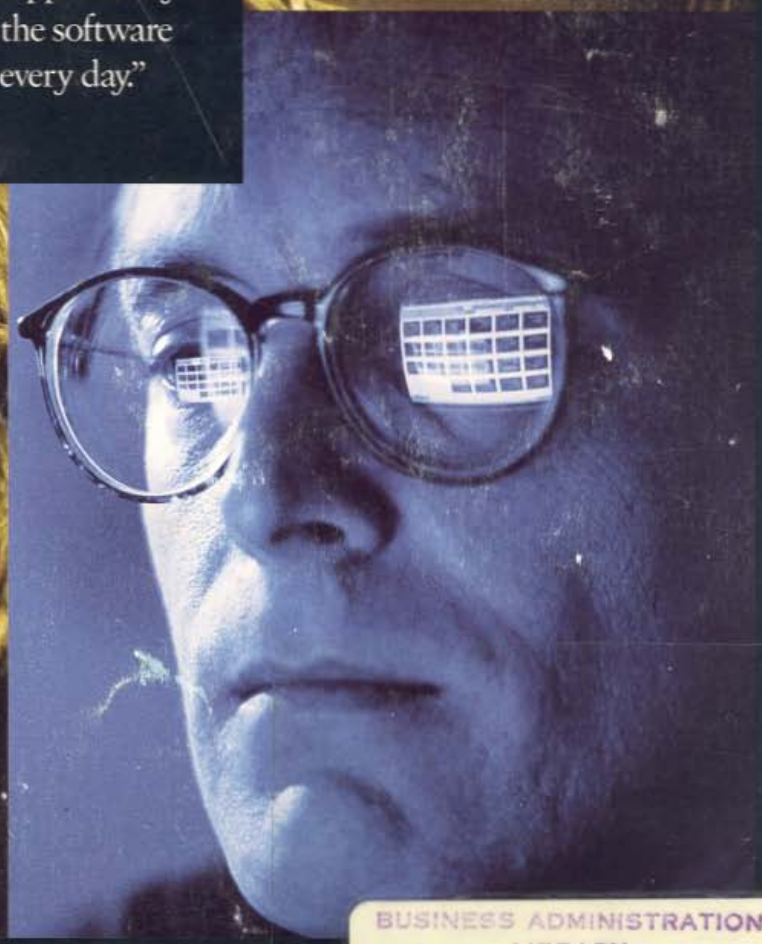
MICROSOFT CORPORATION





"As developers, we have the opportunity to reinvent the software industry every day."



1994 ANNUAL REPORT

At Microsoft, one vision drives everything we do: a computer on every desk and in every home.

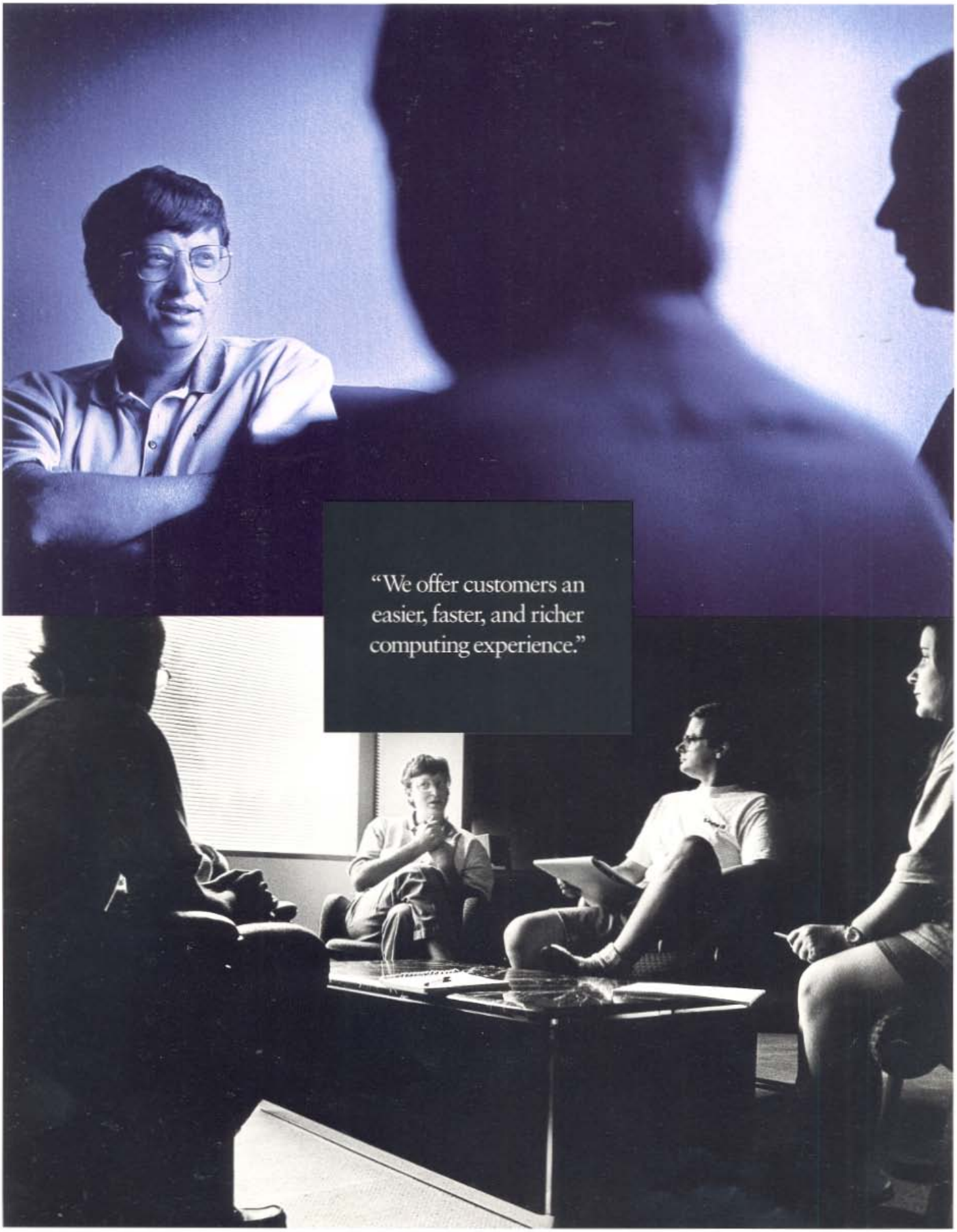
(In millions, except earnings per share)	Year Ended June 30				
	1990	1991	1992	1993	1994
Net revenues	$1,183	$1,843	$2,759	$3,753	$4,649
Net income	279	463	708	953	1,146
Earnings per share	0.52	0.82	1.20	1.57	1.88
Return on net revenues	23.6%	25.1%	25.7%	25.4%	24.7%
Cash and short-term investments	$ 449	$ 686	$1,345	$2,290	$3,614
Total assets	1,105	1,644	2,640	3,805	5,363
Stockholders' equity	919	1,351	2,193	3,242	4,450

Financial Results

Due in large measure to the ongoing success of the Microsoft® Windows™ operating system and Microsoft Office, Microsoft posted its 19th consecutive year of revenue and earnings growth.

Revenues were $4.65 billion in 1994, an increase of 24% over the $3.75 billion recorded the preceding year. Net income totaled $1.15 billion, up 20% from the $953 million of 1993. Earnings per share reached $1.88, compared with $1.57 last year (restated to reflect the Company's two-for-one stock split in May 1994).

In the third quarter of 1994, Microsoft recorded a $120 million pretax charge after a jury verdict in the Stac Electronics patent litigation. In the fourth quarter, Microsoft reached an agreement with Stac to settle the litigation and reversed $30 million of the charge. The net $90 million pretax charge reduced earnings per share for 1994 by $0.10.


"We offer customers an
easier, faster, and richer
computing experience."

A recent *Fortune* survey of U.S. executives selected Microsoft as the most innovative company in America and among the most admired. □ This recognition means a lot to us because innovation is at the heart of Microsoft and software itself. Our commitment to innovation enables us to develop product features designed to meet changing customer needs and to bring to market products that leverage the most current technological advances. In our industry, companies that aren't innovative are soon left behind. □ Microsoft was founded on the simple proposition that personal computers would become empowering tools on every desk and in every home. Our charter has always been to create the software that delivers on this vision. □ The Microsoft Windows operating environment is an essential part of our vision. When we began developing Windows, it was thought by many to be a dead end. Yet as firm believers in the advantages of graphical interfaces and open systems that allow users to benefit from the widest array of hardware and software, we committed our resources. Throughout the late 1980s and early 1990s, we continually updated Windows, improving each release to take advantage of the newest technology available. While some in our industry took a "wait-and-see" attitude, focusing their resources on historically strong MS-DOS®–based applications, we launched a full line of applications designed for Windows. □ Our commitment to Windows has paid off. Today, it is a worldwide phenomenon—popular in more than 25 languages—and a vast majority of personal computers ship with Windows preinstalled. This year, the installed base of Windows doubled to more than 60 million. And we are a leading producer of applications software for Windows. □ Another example of how innovation pays off is Microsoft Office, which integrates our top-rated desktop applications software. When we first combined these products, some observers said it would not appeal to customers—that word processing users were different from spreadsheet users, and that users wouldn't be interested in a package that united the different types of programs.

William H. Gates, Chairman of the Board and Chief Executive Officer

We found that customers not only embraced the concept, but gave us feedback on how we could further refine Office. □ Microsoft committed to advance this product and capture the exploding market opportunity, declaring 1994 the "Year of the Office." We made it more "document-centric" with common commands to reflect how people actually work. We further integrated the individual applications within Office so that the separate programs work together seamlessly. And our sales and support professionals focused on demonstrating the product's capabilities to customers. □ Today, Microsoft Office is by far the top-selling product in what has become the biggest software category. □ Beyond Office, the innovations of the entire Windows platform have also brought success—and not only to us. The expanding global customer base of Windows has opened opportunities for software developers, personal computer manufacturers, and other computer industry businesses. It has provided corporate customers with a foundation on which to build their own development efforts. And it has led to the growth of thousands of companies, including the more than 5,000 independent Microsoft Solution Providers that create custom solutions, support, and training for end users. Our work to encourage Office-compatible applications promises similar prospects.

□ More important, the industrywide momentum behind Windows, Office, and many other Microsoft products has brought great benefits to the millions of people around the world who use computers every day in their jobs, schools, and homes. We offer customers an easier, faster, and richer computing experience, and we've made computing more accessible for everyone by continuously pioneering new ideas, new products, and new customer services. □ During fiscal 1994, we invested in the future and experienced record success. Fiscal 1995 will be another year of investment, as we enter new markets and new product categories. Not only will we make significant investments in research and development, particularly in the business systems and consumer divisions, but also invest in our support organizations and our brand. We take a long-term

Steven A. Ballmer, Executive Vice President, Sales and Support

approach to everything we do, including our investments in people, technology, and customer relationships. □ Many risks and challenges face us: Will hardware sales continue to grow? What will software prices be? How many customers will want to upgrade to the latest versions of our products? Will our business systems and consumer products achieve preeminent positions? □ Over the years ahead, I believe we will mirror our success with Windows and Office in many other product categories. These experiences will guide us as we commit to major investments in new technologies and extend our vision into emerging and wider markets. As has been true throughout the history of the personal computer industry, software will be the key element for realizing the potential of the information highway. The personal computer is evolving, not only in terms of price and performance, but in the very definition of what it is and does. More and more, the computer is becoming a communications tool, the central instrument linking people to information—a future that we've described as "information at your fingertips." Our position in the software industry and our continuing commitment to innovation should allow us to lead in the creation of new products that will define the future. □ Over the next several pages, you'll meet some of the Microsoft people who will help shape that future: members of our product development teams. They are among the real heroes of the personal computer revolution, the men and women defining the technologies of today and tomorrow. □ After reading what they say, I think you'll get a sense of our commitment to creating innovative products and get a glimpse of what the future has in store for all of us.

William H. Gates

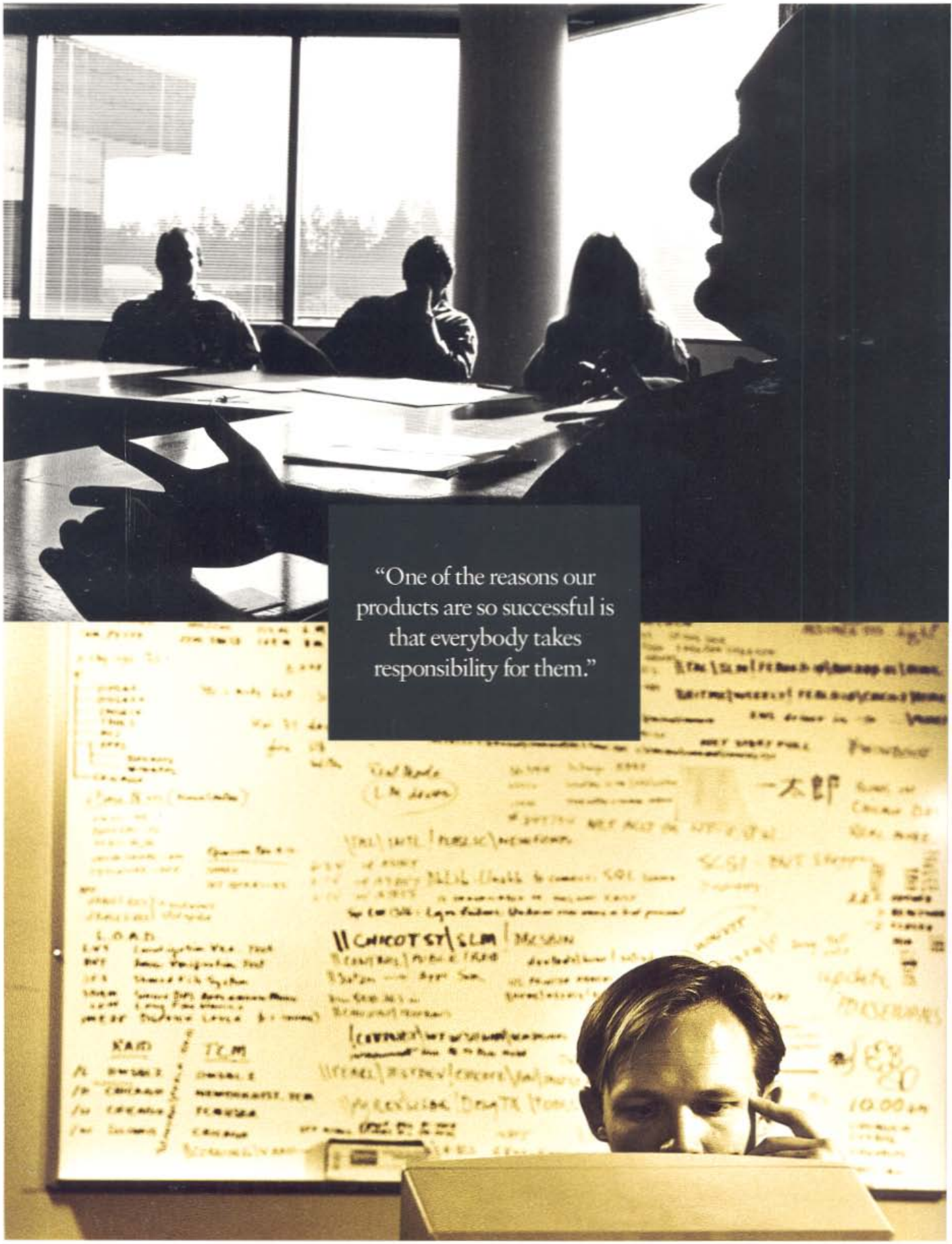
William H. Gates

Michael J. Maples, Executive Vice President, Products

Our products are intellectual in nature, and people are our most important asset. At Microsoft, we nurture an atmosphere in which creative thinking thrives and employees develop to their fullest potential. The high value we place on people inside our company extends to the broader communities in which our employees live and work as well. □ *These beliefs form the basis of our community affairs giving programs, which promote volunteerism in addition to corporate and employee charitable donations. Microsoft is a strong supporter of our employees' individual acts of giving and the organizations that inspire them.* □ *In order to support our employees' community work, we created the Microsoft Volunteer Program (MVP), which encourages grassroots volunteer activities by matching interested Microsoft employees with volunteer service opportunities. We have joined with our employees to support our broader communities through activities such as Kid-Reach, which promotes children's access to technology in Canada; The Microsoft Scholar Program, which retrains unemployed information technology professionals in Europe; and a computer literacy program for disadvantaged children offered through Martha's Table in Washington DC.* □ *To support our employees' economic contributions in the United States and Canada, we provide a program to match the charitable gifts that our employees make. Microsoft also provides corporate financial support and software donations to nonprofit organizations. In 1993, total corporate and employee giving programs generated more than $17 million in donations to charitable organizations worldwide.* □ *In addition, Microsoft operates a wide-ranging environmental program that includes conservation, reuse, and recycling. The success of Microsoft's environmental program is driven by corporate policies and widespread employee adoption. For example, over the past twelve months employees working at Microsoft facilities throughout our Puget Sound headquarters region were responsible for recycling more than 3,200 tons of material that otherwise would have ended up as landfill.*

Microsoft Corporate Campus, Redmond, Washington

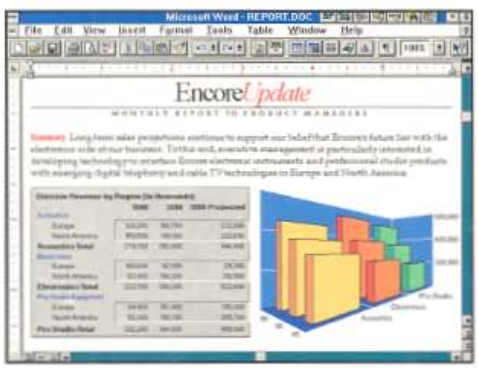
Microsoft Office *Updated to incorporate a highly integrated design and exclusive IntelliSense™ technology, the award-winning Microsoft Office far outdistanced its nearest competitors in the office suite market. More than six million units of Microsoft Office have shipped worldwide, and Office is available on both the Windows and Macintosh® platforms.* **Microsoft Windows** *The installed base for the Microsoft Windows operating system doubled during the year and now stands at more than 60 million units worldwide. More than 400 hardware manufacturers preinstall Windows on their systems, contributing to Microsoft's 61% increase in OEM revenues over last year.* **Microsoft Windows NT** *In 1994, the Microsoft Windows NT™ operating system was adopted by companies across a broad range of industries—including financial, healthcare, accounting, and retail—for use in the development of their own mission-critical applications. Recent enhancements to the Windows NT™ Server offer dramatic performance improvements while providing extensive networking capabilities along with high-level protection for data and applications.* **Microsoft Database and Development Tools** *Microsoft Access® and Microsoft FoxPro® databases, along with the Microsoft Visual Basic® and Microsoft Visual C++™ programming systems, allow for the creation of high-performance multiplatform applications.* **Consumer Division** *Under the banner of the Microsoft Home brand, the consumer division has now put more than 50 products on the shelf, including kid's titles such as Fine Artist and Creative Writer, as well as multimedia titles that include the Microsoft Encarta™ multimedia encyclopedia and the Microsoft Cinemania® interactive movie guide.* **Advanced Technology** *More than 500 people currently work in Microsoft's Advanced Technology Group. They're focused on creating operating systems for next-generation consumer platforms and exploring innovative ways to apply software to future applications such as mobile computing, voice recognition, interactive television, and on-demand video access technology.* **Microsoft Press** *New users, as well as seasoned professionals, look to Microsoft Press as their first source for user-friendly how-to guides and accurate technical information about Microsoft software. Microsoft Press® publications are available worldwide in 30 languages in book and software stores. In addition, Microsoft Press now distributes Microsoft Home CD-ROM products to bookstores.*


"One of the reasons our products are so successful is that everybody takes responsibility for them."

They're called programmers, developers, code sizzlers, and code cowboys. They're responsible for creating the software that millions of people worldwide use every day in their work and in their homes. But who are they, really?

In July, we brought together a cross-section of Microsoft developers to talk about what goes into the actual creation of Microsoft products:

JOHN BENNETT, *a program manager in the workgroup product unit.* GALE DAHLAGER, *a software design tester in digital office systems.* SHAULA DOYLE, *a software design engineer in the consumer division.* ED FRIES, *a development manager for the Microsoft Word group.* KAREN FRIES, *a program manager in the consumer division.* DAN FRUMIN, *a program manager for the Microsoft Access database.* SCOTT ISAACS, *a program manager in the database division.* MARISSA MARTINEZ, *a program manager working on development tools.* DAVID PRITCHARD, *a senior recruiting manager, who led the discussion.* BEN SLIVKA, *a development manager for MS-DOS and Windows systems.* BEN WALDMAN, *a software design engineer working on Microsoft Excel. Here are excerpts from their conversation.*



DAVID: *How would you describe the software development process to your parents and grandparents?*

BENS: It's like building a very complicated machine. Say that a typical automobile has 13,000 parts. A computer program has literally millions of parts.

BENW: It's like a detective story—when you're developing a program, you're constantly trying to figure out why something happens in one case and not in another. Your reward is that after you figure out the mystery, something cool happens on the screen, and you can say, "I did that!" SHAULA: I think there's a huge difference in what I do on a day-to-day basis and what the end user sees. When I go to elementary schools, they say, "What's it like, what do you do?" I almost feel like I'm cheating to say, "I make these great things happen," because it's so much more complicated than that.

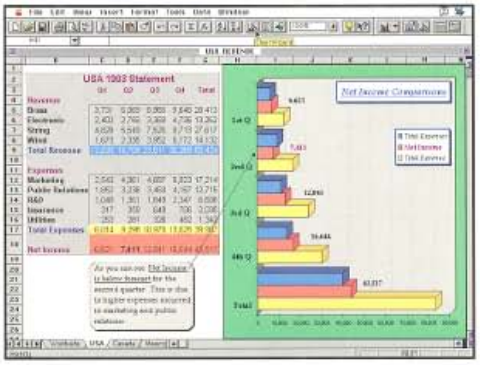
I explain it to them like this: If you look at something like a word processor, it has all these letters in it—A's, B's, C's. At a computer level, each of those letters is a piece of memory called a byte. Well, when we did a Japanese version of Word, we had to deal with all the characters in that language. We used two bytes—two pieces of memory—for those characters. But a developer had to sit down and figure out a system for how the program would know whether the user was typing a one-byte English character or a two-byte Japanese character.

That's one teeny little detail. Now imagine 40 programmers, each doing three or four details like that every day for two years—that's how you get a program done. What I deal with are simple little details like that, and yet all the user sees are the broad strokes.

ED: And that's all we really want them to see.

DAVID: *Can you describe the different development stages in a software project?*

DAN: Every project has a flow—the beginning is the most fun for program managers, because they get to dream. The middle of the project is the most fun for developers and testers, because that's when they get to go in and do their work: writing a bunch of new code, getting features done, fixing bugs. The last cycle of the project is the most fun for marketers because that's when they figure out what trade shows they're going to attend and when they make their final decisions about how they're going to market it. GALE: In the beginning of a project you have this great vision, and at the end you're trying to get it out the door, but the middle is the fun part when things are starting to work. You'll hear someone yell "demo" down the hallway, and people will come streaming into their office to see what got done.



JOHN: Activity-based planning, in which products are designed around end-user activities, has added science to the process. Now we can all sit in a room together and agree why certain things have to be priorities.

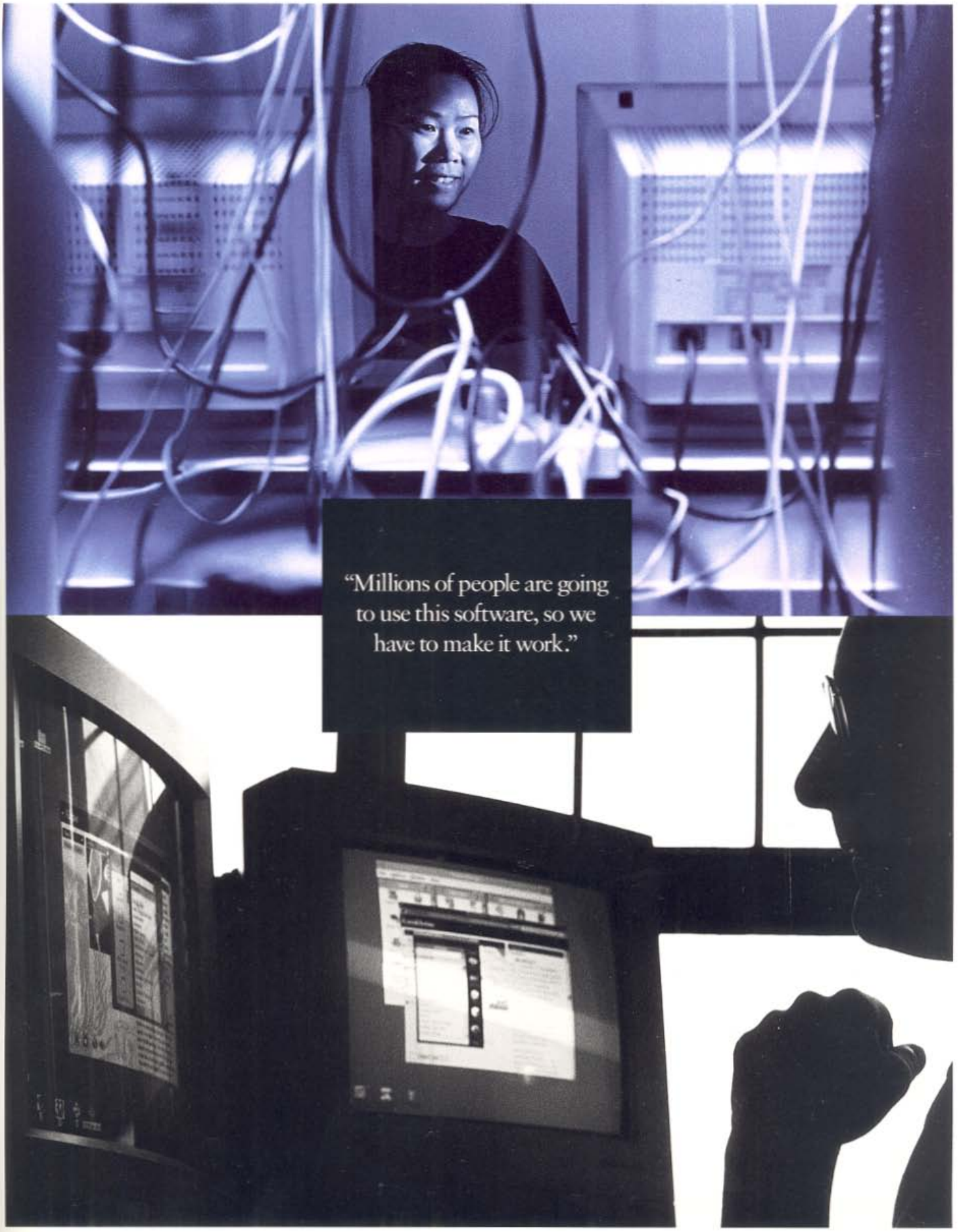
DAVID: *How does it feel to start a new project?*

DAN: It's fun—it's like making your own toy store. All you do for awhile is say, "I wish this toy store had this and this and this and this." JOHN: Wild. It's wild. We always have this struggle early on, where some people want to do research and some people want to start building right away. There's a lot of give-and-take, but we always respect everyone else's opinions and it always comes together. KAREN: The first thing that happens is that you talk to your users and try to figure out what their needs are, where they're having problems, and what's not working. You look at what they're doing and try to figure out "what can we do to make that process easier?" BENW: How can we make it faster, stronger, . . . able to leap tall buildings? ED: It starts with program managers and product marketers talking to users and getting feedback on the last version. The developers do some thinking about what went right and wrong the last time around and what we need to change next time. SCOTT: The person who runs our group has a vision of what he wants our product to be five years out. But the technology can't always meet those expectations, so he starts looking for short-term solutions—things we could develop now so we could start getting feedback from customers. Without his original vision and without that user feedback, the project we're working on couldn't happen. In fact, we're working on some of those features right now—the ones he originally thought wouldn't be in the product for five more years.

DAVID: *Who are the real visionaries in this company?*

[GROUP]: WE are! We ALL are! [laughter]

ED: One of the reasons our products are so successful is that everybody takes responsibility for them. You own this thing; you make it great; you're responsible


"Millions of people are going to use this software, so we have to make it work."

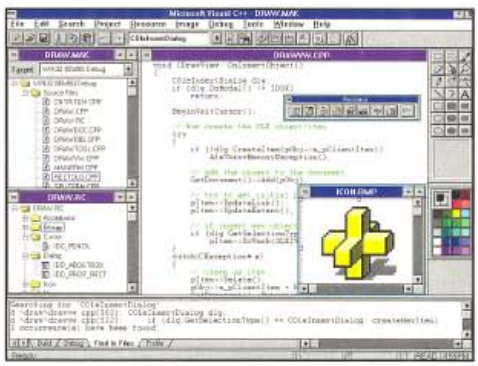
for it. **DAN:** Maybe you believe in something and you know it's not going to happen unless you go out and just push for it. Everybody does that at one time or another at Microsoft. **GALE:** And your input is taken seriously. It doesn't matter what level you're at or where you are. Even if you're in a different group—if you're in product support or working on another product—if you see a design problem or something that can work better, you can give that input to people and it'll get acted on. **DAN:** And we're getting input from outside Microsoft, too. Customers are involved from the beginning. They get to see an alpha (or early version) that's way before the beta; they get to see product specs while there are still significant unknowns. We want to see how they'll react and get end users involved at a stage where we can still do something.

KAREN: And even before that, another important area with customers is usability testing. We had two developers on our project just trying out different ideas and throwing away most of them. One of the huge things that makes this possible are prototyping tools like we have with the Visual Basic programming system. You can try almost fully functional product features, ask customers what works for them and what doesn't, and then make changes without changing an entire program.

DAVID: *Lots of companies develop software—what makes the process different here at Microsoft?*

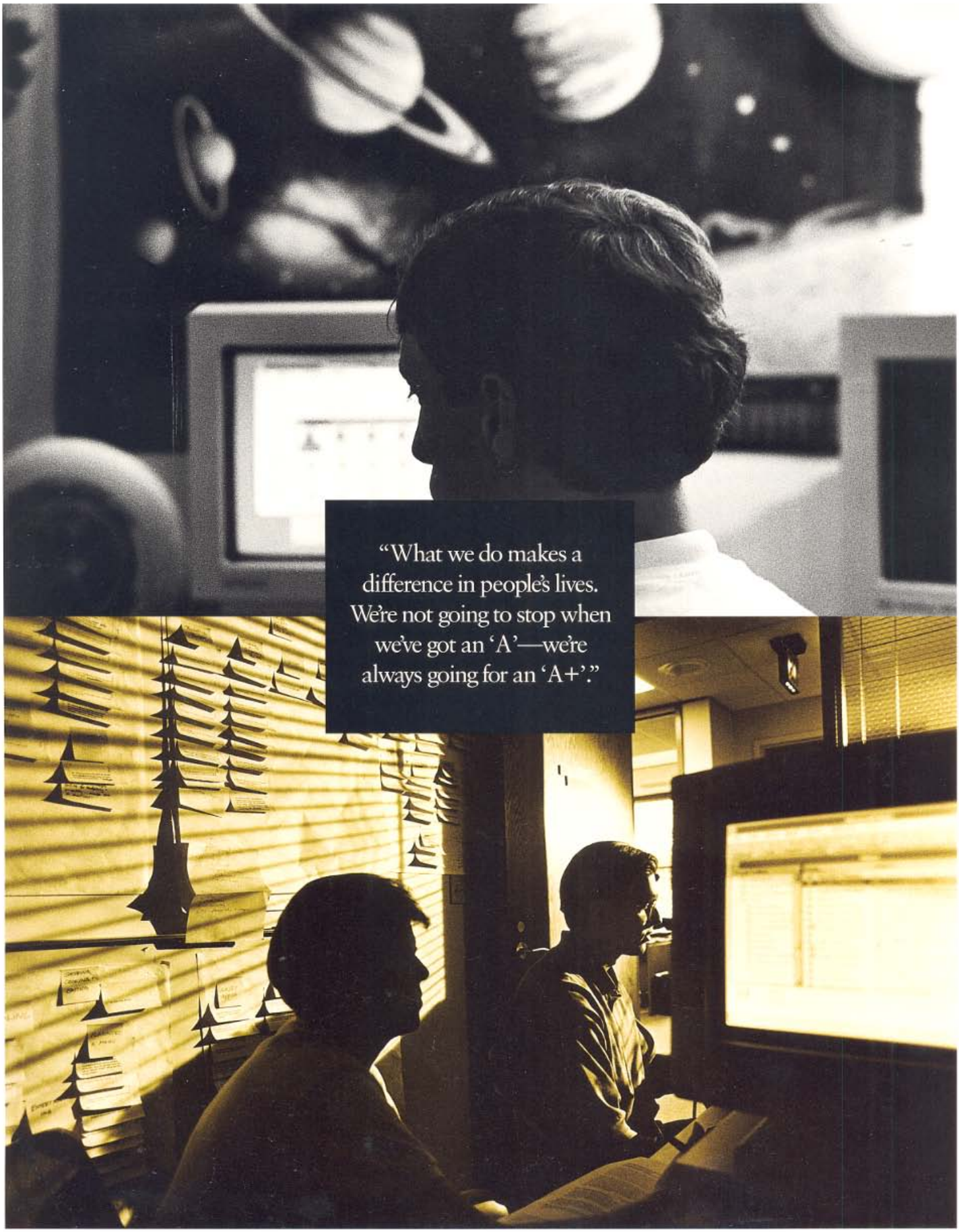
BENS: One observation is that there's not a lot of hierarchy here—you don't have to be a program manager to suggest features; you don't have to be a developer to say that something might be too hard to implement; you don't have to be a tester to say something might be buggy. People play the roles they're able to play, regardless of what title they happen to have. Whereas in a lot of other companies, roles are very rigid and you can't step outside your role. **BENW:** We have a "can-do" attitude at Microsoft; nothing's impossible. We really believe we can do anything. **SCOTT:** As an individual here, if you have an idea, you get to do it. **ED:** Here at Microsoft, we do a lot of our development work in small teams. Even on a big program like Microsoft Word, we break the project up into a lot of small pieces that are developed by small teams. The biggest team on Word is eight people. The original team that did the development for Microsoft Excel, I think, was seven people; so we're at about the same size. **SHAULA:** Decision making is very localized here. A lot of our decisions get made when we go to lunch and talk about what we're doing. **DAN:** We definitely have a good model for interaction, which is the power of our development process. The developer offloads many things to the program manager, and similarly we offload some of the work to testers. Even if the overall product team gets large, you have a pyramid structure that makes it easy to communicate with subteams. **ED:** One of the reasons our software development works is because the decision

making is pushed down. Empowering people is important. **BENW:** I think ultimately it works because Microsoft is full of people who are just super smart; and when problems arise, people come up with a way to work them out. **GALE:** Another thing that makes us unique is that we share a lot of code between groups at Microsoft—not only the development code, but testing tools and other things. So each individual group doesn't have to repeat what another group has already done. **DAN:** An example of that might be the products that have come out of Microsoft that were originally invented to serve internal purposes, like Microsoft Test. A guy in my group originally came up with it, and he designed it just for us, not for the whole company and not to market outside Microsoft. But here was a product that would make testing faster and easier and save us a lot of internal resources. We realized that if it was something we could actually use, more than likely other people could use it, too. Eventually it became a retail product, and now it does pretty well.



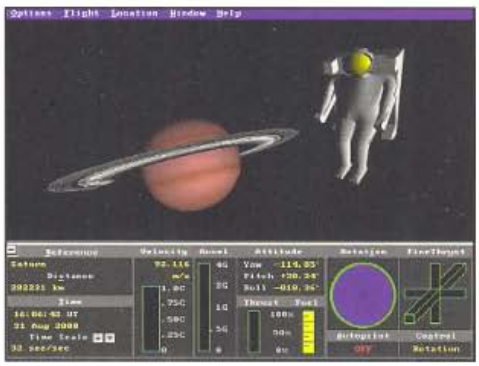
DAVID: *How do you feel when a tester finds a bug in your code?*

BENW: Terrific! **ED:** You lie! [laughter] **BENW:** No, really, I say, "Great, thank you so much." You want them to find as many bugs as possible because you want to get the bugs out of the product. I mean, I might feel embarrassed when someone finds bugs in my product because I want my code to be perfect. But even more, I don't want someone outside, in the real world, to find them first. **DAN:** That's right. One of the good things about our product cycle is that there are people here whose sole job is to find bugs. **ED:** A bug is like solving a puzzle—you track it all the way down into the code, you figure out what's happening, and you fix it. It's a good feeling. But you have a responsibility, too. Millions of people are going to use this software, so we have to make it work. **SHAULA:** There are different kinds of bugs, too. There are bugs when somebody just does something wrong writing the code. All you can do with one of those is say, "Oops, I did something stupid." Then there are bugs that turn out to be a totally unpredictable reaction between two different parts of the program. You can't just fix those or hack them out; you have to really get inside the code to understand them. **BENW:** And there are also what we call "tester bugs," like, "if you do this 10,000 times in a row, this weird thing may happen." We have to evaluate those bugs one by one, because time is an issue and our users aren't going to encounter those problems. **KAREN:** It's such a mystery. Someone once said to me, "If your product is scheduled to ship on October 15, you won't really know if it's going to be ready to go out until around October 1." **ED:** If you even know then—this whole thing is such an art. **BENS:** Regarding the testing we do internally, we try to focus on what we call "code coverage," where we test all the code that was written. But then we have to go


"What we do makes a difference in people's lives. We're not going to stop when we've got an 'A'—we're always going for an 'A+'."

outside the company for beta testing with customers. **MARISSA:** That's because code coverage only tests what the developer put in the product, while the beta tests discover what the developer forgot to put in there. **DAVID:** *What about when you finally ship the product—what's that like? A celebration?*

BENS: You hold your breath. **ED:** The whole shipping process is something that you look back on fondly. But at the time, it's unnerving. It's this awesome responsibility that millions of people are going to be using your product. **BENS:** Shipping is the turning point when you look back at the whole project—beginning to end. You're such a different person at the end. Because you've built something that's really going to affect people. **DAN:** It's fun to see your product in a store and watch customers get ahold of it. **KAREN:** And see how they use it. I can walk down a street, see a flyer, point to it, and say, "That's Publisher clip art."



DAVID: *What makes Microsoft such a great place to work? Is our development different from competitors?* **JOHN:** There are no predefined approaches to our business. In my area, information exchange, none of this has been done before. It makes it exciting, open-ended, and gives us an outlet for creativity. **SCOTT:** Microsoft is very good at gearing you to what you're good at. They might assign me to one thing for awhile, and then when they've seen what I can do, they're flexible enough to move me to another project later.

KAREN: That's right. There's a lot of diversity here—you have the opportunity to work on a wide range of products. **BENW:** It's so cool to be able to say I work at Microsoft. When I've told people I worked on Microsoft Excel, they've literally said, "I want to shake your hand; I use it every day." It amazes me because nine years ago I was a freshman in college; using Microsoft Excel myself. Now, nine years later, I'm leading development on the project. **MARISSA:** The thing I really like about coming to work is that as developers, we have the opportunity to reinvent the software industry every day—to make a change, to make a difference in someone's life.

BENS: Focus. Our focus is to make good products and ship them in vast quantities. We have a sense of mission. **ED:** That focus means we can decide what *not* to do, too; so we can spend our resources wisely. If you look over the past two years and try to figure out how we got ahead, it's because we decided that there were certain things we were going to focus on and do really well. We had far fewer developers than some of our competition had working on their applications. But we've been able to get ahead because we've been smart about what we were going to do and—even more important—smart about what we were not going to do. **BENW:** Every day, everyone makes decisions that affect hundreds of thousands of people all over the world. What we do makes a difference in people's lives. We're not going to stop when we've got an "A"—we're always going for an "A+".

Table of Contents

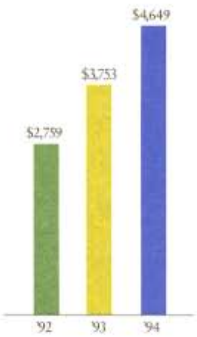
INCOME STATEMENTS

(In millions, except earnings per share)

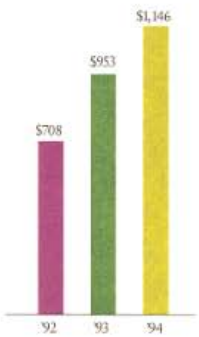
	Year Ended June 30		
	1992	1993	1994
Net revenues	$2,759	$3,753	$4,649
Cost of revenues	467	633	763
Gross profit	2,292	3,120	3,886
Operating expenses:			
Research and development	352	470	610
Sales and marketing	854	1,205	1,384
General and administrative	90	119	166
Total operating expenses	1,296	1,794	2,160
Operating income	996	1,326	1,726
Interest income—net	56	82	102
Litigation charge	—	—	(90)
Other expenses	(11)	(7)	(16)
Income before income taxes	1,041	1,401	1,722
Provision for income taxes	333	448	576
Net income	$ 708	$ 953	$1,146
Earnings per share	$ 1.20	$ 1.57	$ 1.88
Weighted average shares outstanding	588	606	610

See accompanying notes.

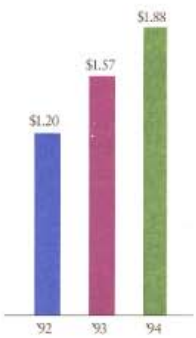
Net Revenues



Net Income



Earnings Per Share



(In millions)

Results of Operations

Overview

Microsoft develops, manufactures, markets, licenses, and supports a wide range of software products, including operating systems for personal computers (PCs), office machines, and personal information devices; applications programs; and languages; as well as personal computer books, hardware, and multimedia products.

Net Revenues

	1992	Change	1993	Change	1994
Net revenues	$2,759	36%	$3,753	24%	$4,649

Product groups. Operating systems product group revenues were $1,104 million, $1,267 million, and $1,519 million in 1992, 1993, and 1994. The MS-DOS operating system is preinstalled on PCs by most original equipment manufacturers (OEMs), and revenues from such licenses increased steadily in both 1993 and 1994. Revenues from retail upgrade versions of MS-DOS decreased in 1994 after a strong increase in 1993. The Microsoft Windows operating system was an increasingly strong contributor to systems revenues as the number of new PCs preinstalled with Windows increased rapidly during the three-year period.

Applications product group revenues were $1,401 million, $2,253 million, and $2,927 million in 1992, 1993, and 1994. Increases in applications revenues were led by strong sales of Microsoft Office. The Microsoft Office Standard product includes Microsoft Excel, Microsoft Word, the Microsoft PowerPoint® presentation graphics program, and a Microsoft Mail license, while the Microsoft Office Professional product also includes the Microsoft Access database. Sales of stand-alone versions of the Microsoft Excel spreadsheet and the Microsoft Word word processor increased in 1993 but decreased in 1994 as the sales mix continued to shift to integrated products.

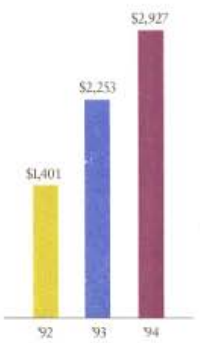
Microsoft Home, a broad range of products in the Company's consumer applications group, also showed continued growth. The Microsoft Home brand includes CD-ROM multimedia library titles and products for children's creativity, personal productivity, and entertainment.

Windows-based software programs represented approximately 85% of applications revenues in 1994, up from 65% in 1992 and 75% in 1993.

Hardware product group revenues were $254 million, $233 million, and $203 million in 1992, 1993, and 1994. The hardware product group's principal products are the Microsoft Mouse and BallPoint® Mouse pointing devices.

Systems Revenues

Applications Revenues



(In millions)

Sales channels. The Company has four major channels of distribution including: finished goods sales in the U.S. and Canada, Europe, and Other International; and OEM. Sales in the finished goods channels are primarily to distributors and resellers. OEM channel revenues are license fees from original equipment manufacturers.

U.S. and Canada channel revenues were $1,062 million, $1,371 million, and $1,575 million in 1992, 1993, and 1994.

Revenues in Europe were $997 million, $1,259 million, and $1,363 million in 1992, 1993, and 1994. Other International channel revenues increased 36% in 1994 to $532 million. Revenues were $223 million in 1992 and $392 million in 1993.

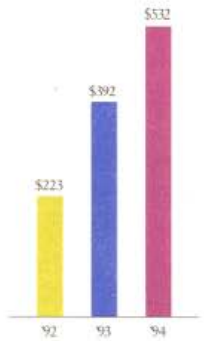
The Company's operating results are affected by foreign exchange rates. Approximately 46%, 44%, and 40% of the Company's revenues were collected in foreign currencies during 1992, 1993, and 1994. Since much of the Company's international manufacturing costs and operating expenses are also incurred in local currencies, the relative impact of exchange rates on net income is less than on revenues.

OEM revenues grew 61% from the prior year to $1,179 million. OEM revenues were $477 million in 1992 and $731 million in 1993. The primary source of OEM revenues is licenses of operating systems, particularly MS-DOS and Microsoft Windows. During 1994, approximately 80% of Windows units were sold through the OEM channel, up from approximately 50% in 1992 and 75% in 1993.

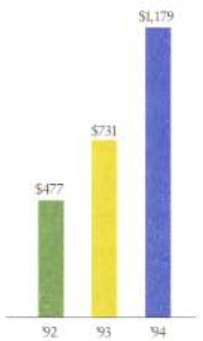
U.S. and Canada Revenues

Europe Revenues

Other International Revenues



OEM Revenues



(In millions, except earnings per share)

Cost of Revenues

	1992	Change	1993	Change	1994
Cost of revenues	$467	36%	$633	21%	$763
Percentage of net revenues	16.9%		16.9%		16.4%

Cost of revenues as a percentage of net revenues was 16.4% in 1994, down from 16.9% in 1992 and 1993. The percentage decreased due to lower disk prices from vendors and a greater percentage of sales of licenses to OEMs and corporations, offset by increased sales of lower-margin Microsoft Office and upgrade products.

Operating Expenses

	1992	Change	1993	Change	1994
Research and development	$352	34%	$ 470	30%	$ 610
Percentage of net revenues	12.8%		12.5%		13.1%
Sales and marketing	$854	41%	$1,205	15%	$1,384
Percentage of net revenues	31.0%		32.1%		29.8%
General and administrative	$ 90	32%	$ 119	39%	$ 166
Percentage of net revenues	3.3%		3.2%		3.6%

Increases in research and development expenses resulted primarily from planned additions to the Company's software development and advanced technology staffs, as well as higher levels of third-party development costs.

In 1994, sales and marketing expenses increased at a slower rate than revenues due to a concerted performance orientation at all sales sites. The increases in the absolute dollars of sales and marketing expenses in 1993 and 1994 were due to increased marketing programs and advertising for the launch of new products, planned hiring of marketing personnel, and continued development of Product Support Services.

Increases in general and administrative expenses are primarily attributable to higher legal costs and growth in the systems and people necessary to support overall increases in the scope of the Company's operations.

Nonoperating Income

	1992	Change	1993	Change	1994
Nonoperating income	$45	67%	$75	15%	$86
Litigation charge	—		—		$90

The primary component of nonoperating income is interest income, which was $58 million, $83 million, and $104 million in 1992, 1993, and 1994. Increased interest income is the result of a larger investment portfolio generated by cash from operations, offset in both 1993 and 1994 by declining interest rates.

In the third quarter of 1994, the Company recorded a $120 million charge to reflect the estimated impact of a jury verdict in the Stac Electronics patent litigation and related expenses. In June 1994, the Company reached an agreement with Stac to settle the litigation and adjusted its estimate accordingly, resulting in a credit of $30 million in the fourth quarter and a net pretax charge of $90 million for the year.

Provision for Income Taxes

	1992	Change	1993	Change	1994
Provision for income taxes	$333	35%	$448	29%	$576
Effective tax rate	32.0%		32.0%		33.5%

The effective tax rate increased in 1994 primarily because of an increase in the U.S. statutory income tax rate. Notes To Financial Statements describe the differences between the U.S. statutory and effective income tax rates.

Net Income and Earnings Per Share

	1992	Change	1993	Change	1994
Net income	$708	35%	$953	20%	$1,146
Percentage of net revenues	25.7%		25.4%		24.7%
Earnings per share	$1.20	31%	$1.57	20%	$ 1.88

Net income as a percentage of net revenues decreased in 1994, primarily due to the Stac Electronics patent litigation charge and increased research and development expenses, offset by the lower relative level of sales and marketing expenses. The slight percentage decrease in 1993 from 1992 was attributable to higher relative sales and marketing expenditures.

Outlook: Issues and Risks

The Company's 1994 Annual Report includes discussions of its long-term growth outlook. The following issues and risks, among others, should also be considered in evaluating its outlook.

Rapid technological change. The personal computer software industry is characterized by rapid technological change and uncertainty as to the widespread acceptance of new products.

Long-term investment cycle. Developing, manufacturing, and licensing software is expensive and the investment in product development often involves a long pay-back cycle. The Company began investing in the principal products that are significant to its current revenues in the early 1980s. The Company's plans for 1995 include significant investments in software research and development and related product opportunities from which significant revenues are not anticipated for a number of years.

Product ship schedules. Delays in the release of new products can cause operational inefficiencies that impact manufacturing capabilities, distribution logistics, and telephone support staffing.

Microsoft Office. Revenues from Microsoft Office may increase as a percentage of total revenues in 1995. The price of Microsoft Office is less than the sum of the prices for the individual application programs included in this product when such programs are sold separately.

Prices. Future prices the Company is able to obtain for its products may decrease from historical levels depending upon market or other cost factors.

Saturation. Product upgrades, enabling users to upgrade from earlier versions of the Company's products or from competitors' products, have lower prices than new products. As the desktop PC software market becomes saturated, the sales mix shifts from standard products to upgrade products. This trend is expected to continue in 1995.

Introductory pricing. The Company has offered certain new products at low introductory prices. This practice may continue with other new product offerings.

Channel mix. Average revenue per license is lower from OEM licenses than from retail versions, reflecting the relatively lower direct costs of operations in the OEM channel. An increasingly higher percentage of revenues was achieved through the OEM channel during 1993 and 1994.

Volume discounts. In 1994, unit sales increased under Microsoft Select, a large account program designed to permit large organizations to license Microsoft products. Average revenue per copy from Select license programs is lower than average revenue per copy from retail versions shipped through the finished goods channels.

Foreign exchange. A large percentage of the Company's sales are transacted in local currencies. As a result, the Company's revenues are subject to foreign exchange rate fluctuations.

Cost of revenues. Although cost of revenues as a percentage of net revenues was relatively consistent in 1993 and 1994, it varies with channel mix and product mix within channels. Changes in channel and product mix, as well as in the cost of product components, may affect cost of revenues as a percentage of net revenues in 1995.

Sales and marketing and support investments. The Company's plans for 1995 include continued investments in its sales and marketing and support groups. Competitors may be able to enter the market without making investments of such scale.

Accounting standards. Accounting standards promulgated by the Financial Accounting Standards Board change periodically. Changes in such standards, including currently proposed changes in the accounting for employee stock option plans, may have a negative impact on the Company's future reported earnings.

Unlicensed copying. Unlicensed copying of software represents a loss of revenues to the Company. The Company is actively educating consumers and lawmakers on this issue. However, there can be no assurance that continued efforts will affect revenues positively.

Growth rates. Management believes the Company's recent revenue growth rates are not sustainable. Operating expenses as a percentage of revenues may increase in 1995 because of the above factors, among others.

(In millions)

Litigation. Litigation regarding intellectual property rights, patents, and copyrights is increasing in the PC software industry. In addition, there are other general corporate legal risks. See Notes To Financial Statements regarding contingencies related to government regulation and legal proceedings.

Financial Condition

The Company's cash and short-term investments totaled $3,614 million at June 30, 1994 and represented 67% of total assets. The portfolio is diversified among security types, industries, and individual issuers. The Company's investments are investment grade and liquid.

Microsoft has no material long-term debt. Stockholders' equity at June 30, 1994 was over $4.4 billion.

Cash generated from operations has been sufficient to fund the Company's investment in research and development activities and facilities expansion. As the Company grows, investments will continue in research and development in existing and advanced areas of technology. The Company's cash will be used to acquire technology or to fund strategic ventures. Additions to property, plant, and equipment are expected to continue, including facilities and computer systems for research and development, sales and marketing, product support, and administrative staff.

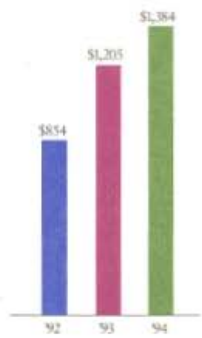
The exercise of stock options by employees provides additional cash. These proceeds have funded the Company's open market stock repurchase program through which Microsoft provides shares for stock option and stock purchase plans. This practice is expected to continue in 1995.

The Company has available $70 million of standby multicurrency lines of credit. These lines support foreign currency hedging and international cash management.

Management believes existing cash and short-term investments together with funds generated from operations will be sufficient to meet the Company's operating requirements in 1995.

Research and Development Spending

Sales and Marketing Spending



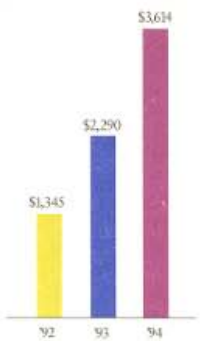
CASH FLOWS STATEMENTS

(In millions)

	Year Ended June 30		
	1992	1993	1994
Cash flows from operations			
Net income	$ 708	$ 953	$1,146
Depreciation and amortization	112	151	237
Current liabilities	167	177	360
Accounts receivable	(33)	(121)	(146)
Inventories	(40)	(51)	23
Other current assets	(18)	(35)	(27)
Net cash from operations	896	1,074	1,593
Cash flows from financing			
Common stock issued	135	229	280
Common stock repurchased	(135)	(250)	(348)
Stock option income tax benefits	130	207	151
Net cash from financing	130	186	83
Cash flows used for investments			
Additions to property, plant, and equipment	(317)	(236)	(278)
Other assets	(41)	(17)	(64)
Short-term investments	(284)	(723)	(860)
Net cash used for investments	(642)	(976)	(1,202)
Net change in cash and equivalents	384	284	474
Effect of exchange rates	(10)	(62)	(10)
Cash and equivalents, beginning of year	417	791	1,013
Cash and equivalents, end of year	791	1,013	1,477
Short-term investments	554	1,277	2,137
Cash and short-term investments	$1,345	$2,290	$3,614

See accompanying notes.

Cash and Short-Term Investments



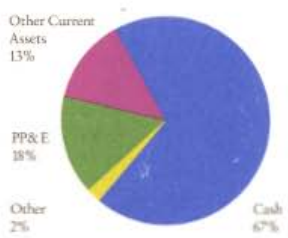
BALANCE SHEETS

(In millions)

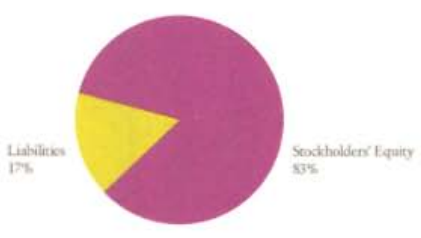
	June 30	
	1993	1994
Assets		
Current assets:		
Cash and short-term investments	$2,290	$3,614
Accounts receivable—net of allowances of $76 and $92	338	475
Inventories	127	102
Other	95	121
Total current assets	2,850	4,312
Property, plant, and equipment—net	867	930
Other assets	88	121
Total assets	$3,805	$5,363
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 239	$ 324
Accrued compensation	86	96
Income taxes payable	127	305
Other	111	188
Total current liabilities	563	913
Commitments and contingencies		
Stockholders' equity:		
Common stock and paid-in capital—shares authorized 2,000; issued and outstanding 565 and 581	1,086	1,500
Retained earnings	2,156	2,950
Total stockholders' equity	3,242	4,450
Total liabilities and stockholders' equity	$3,805	$5,363

See accompanying notes.

Assets - 1994



Liabilities and Stockholders' Equity - 1994



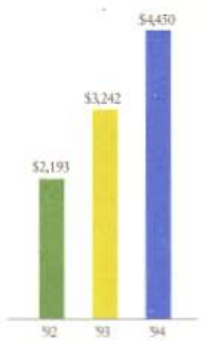
STATEMENTS OF STOCKHOLDERS' EQUITY

(In millions)

	Year Ended June 30		
	1992	1993	1994
Common stock and paid-in capital			
Balance, beginning of year	$ 395	$ 657	$1,086
Common stock issued	135	229	280
Common stock repurchased	(3)	(7)	(17)
Stock option income tax benefits	130	207	151
Balance, end of year	657	1,086	1,500
Retained earnings			
Balance, beginning of year	956	1,536	2,156
Common stock repurchased	(132)	(243)	(331)
Net income	708	953	1,146
Translation adjustment	4	(90)	(21)
Balance, end of year	1,536	2,156	2,950
Total stockholders' equity	$2,193	$3,242	$4,450

See accompanying notes.

Stockholders' Equity



Employee Stock Options

At Microsoft, every employee is eligible to become a stockholder in the Company through the Company's employee stock purchase and stock option plans. Management believes stock options have made a major contribution to the success of the Company by aligning employee interests with those of other stockholders. Stock options are in widespread use today, and many of the Company's competitors have similar programs.

During the last several years there has been considerable debate about the appropriate accounting for stock options. Questions in this ongoing discussion include how stock options should be measured; whether they should be recorded in traditional financial statements, subject to already complex and increasingly difficult rules; whether they should be highlighted in a separate new financial statement or table; or whether further information concerning stock options should be disclosed in footnotes to financial statements. Pending resolution of these outstanding issues, on the accompanying page we have provided a table of outstanding common shares and net options and changes in their computed values based on quoted prices for the Company's stock. It provides a clear understanding of the Company's equity, its equity holders, and the value or possible value of their vested and unvested holdings.

In this table, common shares are those outstanding. Net vested and unvested options represent the number of common shares issuable upon exercise of such stock options less the number of common shares that could be repurchased with proceeds from their exercise. Computed values are calculated based on the closing price of the Company's common stock on the Nasdaq National Market System on the dates indicated.

Stakeholdings - 1994

(In millions)

	June 30				
	1992	Change	1993	Change	1994
Outstanding common shares and options					
Directors' and officers' common shares	273	(13)	260	(21)	239
Employees' and directors' net vested and unvested stock options	78	(11)	67	(5)	62
Employees' and directors' shares and options	351	(24)	327	(26)	301
Other investors' common shares	271	34	305	37	342
Total	622	10	632	11	643
Nasdaq closing price per share	$35		$44		$51-5/8
Computed values					
Directors' and officers' common shares	$ 9,579	$1,886	$11,465	$ 845	$12,310
Employees' and directors' net vested and unvested stock options	2,714	245	2,959	269	3,228
Employees' and directors' shares and options	12,293	2,131	14,424	1,114	15,538
Other investors' common shares	9,486	3,930	13,416	4,259	17,675
Total	$21,779	$6,061	$27,840	$5,373	$33,213

Significant Accounting Policies

Principles of consolidation. The financial statements include the accounts of Microsoft and its wholly owned subsidiaries. Significant intercompany transactions and balances have been eliminated.

Foreign currencies. Current assets and liabilities denominated in foreign currencies are translated at the exchange rate on the balance sheet date. Fixed assets and resulting depreciation are translated at historical rates. Translation adjustments resulting from this process are charged or credited to equity. Revenues, costs, and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in other expenses.

Revenue recognition. Revenue from finished goods sales to distributors and resellers is recognized when related products are shipped. Revenue billed upon shipment of finished goods products attributable to both specified and unspecified future product enhancements is deferred and recognized when such enhancements are delivered. Revenue from software maintenance contracts is recognized ratably over the contract period.

The Company warrants products against defects and has policies permitting the return of products under certain circumstances. Provision is made for warranty costs and returns. Such costs generally have not been material.

Revenue from products licensed to original equipment manufacturers is recognized when the licensed products are shipped by the OEM. License fees received prior to product acceptance are recorded as customer deposits.

Provision is made for bad debts. Such costs generally have not been material.

Research and development. Research and development costs are expensed as incurred.

Income taxes. Income tax expense includes U.S. and international income taxes, plus an accrual for U.S. taxes on undistributed earnings of international subsidiaries. Certain items of income and expense are not reported in tax returns and financial statements in the same year. The tax effect of this difference is reported as deferred income taxes. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

Earnings per share. Earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options, computed using the treasury stock method.

Stock split. In May 1994, outstanding shares of common stock were split two-for-one. All shares and per share amounts have been restated.

Cash and short-term investments. The Company considers all liquid investments with a maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments are stated at the lower of cost or market. Cost approximates market value for all classifications of cash and short-term investments.

Inventories. Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property, plant, and equipment. Property, plant, and equipment is stated at cost and depreciated using the straight-line method. Estimated lives are as follows: buildings, 30 years; leasehold improvements, the lease term; computer equipment and other, principally three years.

Diversification of risk. The Company's investment portfolio is diversified and consists of short-term investment grade securities. At June 30, 1993 and 1994, approximately 40% of accounts receivable represented amounts due from ten channel purchasers. Two of these each accounted for approximately 10% of revenues in 1993 and 13% in 1994. The Company hedges certain foreign exchange exposures although no material hedge contracts were outstanding at June 30, 1994.

Statements of Financial Accounting Standards (SFAS). SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed,* does not materially affect the Company. SFAS No. 109, *Accounting for Income Taxes*, was adopted in 1994, and the effect on current year and cumulative net income was not material. Required adoption of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* in the first quarter of 1995 will not have a material impact on the financial statements. In its current form, a proposed new SFAS, *Accounting for Stock-based Compensation,* if adopted, is expected to have a material adverse effect on the way future net income is reported.

Reclassifications. Certain reclassifications have been made for consistent presentation.

(In millions)

Cash and Short-Term Investments

	June 30	
	1993	1994
Cash and equivalents:		
Cash	$ 225	$ 263
Commercial paper	326	619
Money market preferreds	159	180
Certificates of deposit	160	218
Bank loan participations	143	197
Cash and equivalents	1,013	1,477
Short-term investments:		
Municipal securities	788	1,245
Corporate notes and bonds	226	423
U.S. Treasury securities	199	417
Commercial paper	64	52
Short-term investments	1,277	2,137
Cash and short-term investments	$2,290	$3,614

Property, Plant, and Equipment

	June 30	
	1993	1994
Land	$ 144	$ 162
Buildings	389	440
Computer equipment	415	532
Other	233	311
Property, plant, and equipment—at cost	1,181	1,445
Accumulated depreciation	(314)	(515)
Property, plant, and equipment—net	$ 867	$ 930

Income Taxes

The provision for income taxes was composed of:

	1992	1993	1994
Current taxes:			
U.S. and state	$225	$352	$470
International	112	123	94
Current taxes	337	475	564
Deferred taxes	(4)	(27)	12
Provision for income taxes	$333	$448	$576

Differences between the U.S. statutory and effective tax rates were:

	1992	1993	1994
U.S. statutory rate	34.0%	34.0%	35.0%
Tax exempt income	(0.6)	(0.6)	(0.9)
Foreign sales corporation	(1.0)	(1.0)	(1.0)
Tax credits	(1.1)	(0.9)	(2.1)
State taxes and other—net	0.7	0.5	2.5
Effective tax rate	32.0%	32.0%	33.5%

Deferred income tax balances were:

	June 30
	1994
Deferred income tax assets:	
Gross margin items	$ 72
Expense items	132
Deferred income tax assets	204
Deferred income tax liabilities:	
International earnings	(147)
Other	(4)
Deferred income tax liabilities	(151)
Net deferred income tax asset	$ 53

U.S. and international components of income before income taxes were:

	1992	1993	1994
U.S.	$ 658	$ 960	$1,281
International	383	441	441
Income before income taxes	$ 1,041	$1,401	$1,722

The Internal Revenue Service is examining the Company's U.S. income tax returns for 1990 and 1991. The Company believes any adjustments from the examination will not be material. Income taxes paid were $175 million, $187 million, and $247 million in 1992, 1993, and 1994.

Common Stock

Shares of common stock outstanding were as follows:

	1992	1993	1994
Balance, beginning of year	522	544	565
Issued	26	27	25
Repurchased	(4)	(6)	(9)
Balance, end of year	544	565	581

The Company repurchases its common stock in the open market to provide shares for issuance to employees under stock option and stock purchase plans. The Company's Board of Directors authorized continuation of this program in 1995.

In June 1994, the Company merged with SOFTIMAGE, Inc. (SI), a leading developer of 2-D and 3-D computer animation and visualization software, in a pooling of interests. The Company exchanged 2.7 million shares, shown as outstanding at June 30, 1994, for all of the outstanding stock of SI.

(In millions, except per share data)

SI's assets and liabilities, which were nominal, are included with those of Microsoft as of June 30, 1994. Operating results for SI during 1992, 1993, and 1994 were not material to the combined results of the two companies. Accordingly, the financial statements for such periods have not been restated.

Employee Stock and Savings Plans

Employee stock purchase plan. The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1992, 1993, and 1994, employees purchased 0.9 million, 1.0 million, and 1.1 million shares at average prices of $24.59, $33.29, and $34.16 per share. At June 30, 1994, 6.5 million shares were reserved for future issuance.

Savings plan. The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Under the plan, participating U.S. employees may defer up to 15% of their pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar contributed by a participant, with a maximum contribution of 3% of a participant's earnings. The Company's matching contributions to the savings plan were $5 million, $7 million, and $9 million in 1992, 1993, and 1994.

Stock option plans. The Company has stock option plans for directors, officers, and all employees, which provide for nonqualified and incentive stock options. The Board of Directors determines the option price (not to be less than fair market value for incentive options) at the date of grant. The options generally expire ten years from the date of grant and vest over four and one-half years. At June 30, 1994, options for 52.6 million shares were vested and 111.0 million shares were available for future grants under the plans.

	Outstanding Options		
		Price Per Share	
	Number	Range	Weighted Average
Balance, June 30, 1991	115.0	$ 0.31 – 22.39	$ 8.27
Granted	29.7	20.59 – 39.79	23.77
Exercised	(20.7)	0.31 – 16.61	6.50
Canceled	(3.7)	1.50 – 38.84	7.39
Balance, June 30, 1992	120.3	0.31 – 39.79	12.44
Granted	24.4	30.88 – 44.25	34.30
Exercised	(26.2)	0.31 – 36.92	7.95
Canceled	(4.4)	4.97 – 44.13	14.23
Balance, June 30, 1993	114.1	0.31 – 44.25	18.06
Granted	26.2	35.50 – 50.13	37.47
Exercised	(20.9)	1.51 – 44.25	11.42
Canceled	(5.5)	5.01 – 44.13	28.67
Balance, June 30, 1994	113.9	0.31 – 50.13	23.29

Leases

The Company has operating leases for most U.S. and international sales and support offices and certain equipment. Rental expense for operating leases was $44 million, $54 million, and $68 million in 1992, 1993, and 1994. Future minimum rental commitments under noncancelable leases, in millions of dollars, are: 1995, $67; 1996, $49; 1997, $38; 1998, $32; 1999, $24; and thereafter, $22.

Contingencies

On July 15, 1994, Microsoft entered into an undertaking with the Commission of the European Communities (European Commission) resolving a complaint submitted by Novell, Inc. claiming that certain practices of Microsoft violated Articles 85 and 86 of the Treaty of Rome. The undertaking is effective immediately, requires no further approval, and closes the investigation of Novell's complaint by the European Commission's Directorate-General for Competition. In the undertaking, which involves no admission of wrongdoing on Microsoft's part, Microsoft agreed to make certain changes in its OEM licensing practices. Microsoft also agreed to employ a uniform duration in its nondisclosure agreements for precommercial

versions of certain operating system products, and clarified the rights and responsibilities of those signing such nondisclosure agreements. The European Commission has the right to monitor Microsoft's compliance during the 6-1/2 year term of the settlement agreement.

On July 15, 1994, Microsoft and the U.S. Department of Justice (DOJ) entered into a consent decree resolving the DOJ's nonpublic investigation of Microsoft. The consent decree contained the same provisions as the undertaking between Microsoft and the European Commission. To become final, the consent decree must be approved by the U.S. District Court for the District of Columbia. The Court's consideration of the consent decree and any comments and responses submitted concerning it will occur no sooner than 60 days after publication of the consent decree in the Federal Register.

Microsoft does not expect the undertaking with the European Commission or the consent decree with the DOJ to affect its OEM revenues.

On March 17, 1988, Apple Computer, Inc. (Apple) brought suit against Microsoft and Hewlett-Packard Company for alleged copyright infringement in the U.S. District Court, Northern District of California. The complaint included allegations that the visual displays of Microsoft Windows version 2.03 (and Windows version 3.0, which was added to the complaint later) infringed Apple's copyrights and exceeded the scope of a 1985 Settlement Agreement between Microsoft and Apple. The complaint sought to enjoin Microsoft from marketing Microsoft Windows versions 2.03 and 3.0 or any derivative work based on Windows 2.03 or 3.0 and from otherwise infringing Apple's copyrights and sought damages resulting from the alleged infringement.

The Company answered the complaint, raising affirmative defenses including its claim that the 1985 Settlement Agreement entitled it to use the visual displays in question, denying Apple's allegations that the visual displays in Microsoft Windows version 2.03 and 3.0 infringe any protectible right of Apple and asserting counterclaims.

On August 24, 1993, the Court entered final judgment dismissing all of Apple's claims. Apple has appealed a number of the Court's decisions in the case to the Ninth Circuit Court of Appeals. Microsoft has cross-appealed the dismissal of one of its counterclaims and related issues. Oral argument on the appeal and cross-appeal was heard by Judges Ferdinand Fernandez, Pamela Rymer, and Thomas Nelson on July 11, 1994.

On July 30, 1993 Wang Laboratories, Inc. (Wang) filed suit in U.S. District Court for the District of Massachusetts against Microsoft and Watermark Software, Inc., alleging that unspecified Microsoft products infringe two patents owned by Wang concerning object management and the handling of compound documents (United States Patents 5,206,951 issued on April 27, 1993, and 5,129,061 issued on July 7, 1992, respectively). The suit also alleges that Microsoft induced and continues to induce others, including Watermark Software, Inc., to infringe the Wang patents. Microsoft's OLE technology appears to be the subject of Wang's allegations against Microsoft. The complaint seeks a determination that Microsoft's alleged infringement is willful, an award of treble damages, an award of attorneys' fees, and to preliminarily and permanently enjoin Microsoft from continuing the alleged infringement. In its answer, Microsoft denied that any of its products infringe the Wang patents and asked the Court for a declaratory judgment that those patents are invalid and unenforceable for failing to meet patent law requirements. The suit is currently in the early stages of discovery.

Although there is no assurance that these lawsuits will be resolved favorably and that the Company's financial condition will not be adversely affected, the Company currently believes that resolution of these matters will not have material adverse effects on its financial condition as reported in the accompanying financial statements.

(In millions)

Information by Geographic Area

	1992	1993	1994
Net revenues			
U.S. operations	$1,878	$ 2,655	$3,472
European operations	1,019	1,289	1,401
Other international operations	272	395	375
Eliminations	(410)	(586)	(599)
Total net revenues	$2,759	$ 3,753	$4,649
Operating income			
U.S. operations	$ 664	$ 961	$1,394
European operations	329	360	346
Other international operations	11	18	31
Eliminations	(8)	(13)	(45)
Total operating income	$ 996	$ 1,326	$1,726
Identifiable assets			
U.S. operations	$1,858	$ 2,944	$4,397
European operations	872	1,133	1,366
Other international operations	289	310	423
Eliminations	(379)	(582)	(823)
Total identifiable assets	$2,640	$ 3,805	$5,363

Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. "U.S. operations" include shipments to customers in the U.S., licensing to OEMs, and exports of finished goods directly to international customers, primarily in Canada, South America, and Asia. Exports and international OEM transactions are primarily in U.S. dollars and totaled $255 million, $426 million, and $787 million in 1992, 1993, and 1994. "Other international operations" primarily include subsidiaries in Australia, Japan, Korea, and Taiwan. International revenues, which include European operations, other international operations, exports, and OEM distribution, were 55.1%, 55.3%, and 54.0% of total revenues in 1992, 1993, and 1994.

QUARTERLY FINANCIAL AND MARKET INFORMATION

(In millions, except per share data; unaudited)

	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
1992					
Net revenues	$ 581	$ 682	$ 681	$ 815	$ 2,759
Gross profit	476	567	571	678	2,292
Net income	144	175	179	210	708
Earnings per share	0.25	0.30	0.30	0.35	1.20
Common stock price per share:					
High	30	37-3/8	44-1/2	43-1/8	44-1/2
Low	20-1/8	28-7/5	36-1/2	32-7/8	20-1/8
1993					
Net revenues	$ 818	$ 938	$ 958	$ 1,039	$ 3,753
Gross profit	683	781	797	859	3,120
Net income	209	236	243	265	953
Earnings per share	0.35	0.39	0.40	0.43	1.57
Common stock price per share:					
High	41	47-1/2	47-1/8	49	49
Low	32-3/4	37-7/8	38-3/8	39-7/8	32-3/4
1994					
Net revenues	$ 983	$ 1,129	$ 1,244	$ 1,293	$ 4,649
Gross profit	824	944	1,036	1,082	3,886
Net income	239	289	256	362	1,146
Earnings per share	0.39	0.48	0.42	0.59	1.88
Common stock price per share:					
High	44-1/4	43-1/4	44-5/8	54-5/8	54-5/8
Low	35-1/8	38	39	41	35-1/8

The Company has not paid cash dividends on its common stock. The Company's common stock is traded on the over-the-counter market and is quoted on the Nasdaq National Market System under the symbol MSFT. On July 29, 1994, there were 26,790 holders of record of the Company's common stock.

SELECTED FIVE-YEAR FINANCIAL DATA

(In millions, except employee and per share data)

	Year Ended June 30				
	1990	1991	1992	1993	1994
For the year					
Net revenues	$ 1,183	$ 1,843	$ 2,759	$ 3,753	$ 4,649
Cost of revenues	253	362	467	633	763
Gross profit	930	1,481	2,292	3,120	3,886
Research and development	181	235	352	470	610
Sales and marketing	317	534	854	1,205	1,384
General and administrative	39	62	90	119	166
Total operating expenses	537	831	1,296	1,794	2,160
Operating income	393	650	996	1,326	1,726
Interest income—net	31	37	56	82	102
Litigation charge	—	—	—	—	(90)
Other expenses	(14)	(16)	(11)	(7)	(16)
Income before income taxes	410	671	1,041	1,401	1,722
Provision for income taxes	131	208	333	448	576
Net income	$ 279	$ 463	$ 708	$ 953	$ 1,146
At year end					
Working capital	$ 533	$ 735	$ 1,323	$ 2,287	$ 3,399
Total assets	$ 1,105	$ 1,644	$ 2,640	$ 3,805	$ 5,363
Stockholders' equity	$ 919	$ 1,351	$ 2,193	$ 3,242	$ 4,450
Number of employees	5,635	8,226	11,542	14,430	15,257
Common stock data					
Earnings per share	$ 0.52	$ 0.82	$ 1.20	$ 1.57	$ 1.88
Cash and short-term investments per share	$ 0.88	$ 1.31	$ 2.47	$ 4.05	$ 6.22
Average common and equivalent shares outstanding	537	563	588	606	610
Shares outstanding at year end	512	522	544	565	581
Key ratios					
Current ratio	3.9	3.5	4.0	5.1	4.7
Return on net revenues	23.6%	25.1%	25.7%	25.4%	24.7%
Return on average total assets	30.6%	33.7%	33.1%	29.6%	25.0%
Return on average stockholders' equity	37.7%	40.8%	40.0%	35.1%	29.8%
Growth percentages—increases					
Net revenues	47%	56%	50%	36%	24%
Net income	63%	66%	53%	35%	20%
Earnings per share	55%	58%	47%	31%	20%

Report of Management

Management is responsible for preparing the Company's financial statements and related information that appears in this annual report. Management believes that the financial statements fairly reflect the form and substance of transactions and reasonably present the Company's financial condition and results of operations in conformity with generally accepted accounting principles. Management has included in the Company's financial statements amounts that are based on estimates and judgments, which it believes are reasonable under the circumstances.

The Company maintains a system of internal accounting policies, procedures, and controls intended to provide reasonable assurance, at appropriate cost, that transactions are executed in accordance with Company authorization and are properly recorded and reported in the financial statements, and that assets are adequately safeguarded.

Deloitte & Touche audits the Company's financial statements in accordance with generally accepted auditing standards and provides an objective, independent review of the fairness of reported financial condition and results of operations.

The Microsoft Board of Directors has an Audit Committee composed of nonmanagement Directors. The Committee meets with financial management, internal auditors, and the independent auditors to review internal accounting controls and accounting, auditing, and financial reporting matters.

Michael W. Brown
Vice President, Finance;
Chief Financial Officer

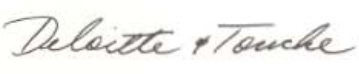
Report of Independent Auditors

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1993 and 1994, and the related statements of income, stockholders' equity, and cash flows for each of the three years in the period ended June 30, 1994, appearing on pages 17, 23, 24, 25, and 28–32. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 1993 and 1994, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 1994 in conformity with generally accepted accounting principles.



Deloitte & Touche
Seattle, Washington
July 20, 1994

Directors

William H. Gates	Chairman of the Board and Chief Executive Officer, Microsoft Corporation
Paul G. Allen	Chairman, Asymetrix Corp., Starwaves Corp., Interval Research, Ticketmaster Holdings Group
Richard A. Hackborn	Executive Vice President, Hewlett-Packard Company (retired)
David F. Marquardt	General Partner, Technology Venture Investors
Robert D. O'Brien	Chairman of the Board, PACCAR, Inc. (retired)
Wm. G. Reed, Jr.	Chairman, Simpson Investment Company
Jon A. Shirley	President and Chief Operating Officer, Microsoft Corporation (retired)

Officers

William H. Gates	Chairman of the Board and Chief Executive Officer
Steven A. Ballmer	Executive Vice President, Sales and Support
Michael J. Maples	Executive Vice President, Products
Roger Heinen	Senior Vice President, Developer Division
Frank M. (Pete) Higgins	Senior Vice President, Desktop Applications
Joachim Kempin	Senior Vice President, OEM Sales Division
Paul A. Maritz	Senior Vice President, Systems Division
Nathan P. Myhrvold	Senior Vice President, Advanced Technology
William H. Neukom	Senior Vice President, Law and Corporate Affairs; Corporate Secretary
Jeffrey S. Raikes	Senior Vice President, North America
Bernard P. Vergnes	Senior Vice President, Microsoft; President, Microsoft Europe
James E. Allchin	Vice President, Business Systems Division
Michael W. Brown	Vice President, Finance; Chief Financial Officer
Raymond A. Emery	Vice President, Operations
Richard Fade	Vice President, Advanced Technology Sales
Michel Lacombe	Vice President, End User Customer Unit, Europe
Jonathan D. Lazarus	Vice President, Strategic Relations
Robert L. McDowell	Vice President, Strategic Enterprise Services
Craig Mundie	Vice President, Advanced Consumer Technology
Mike Murray	Vice President, Human Resources and Administration
Chris Peters	Vice President, Office Product Unit
Richard Rashid	Vice President, Research
Darryl E. Rubin	Vice President, Software Strategy
Brad A. Silverberg	Vice President, Personal Operating Systems Division
Rolf Skoglund	Vice President, Organization Customer Unit, Europe
Christopher F. Smith	Vice President, International Operations
Charles Stevens	Vice President, Far East
Patricia Q. Stonesifer	Vice President, Consumer Division
Deborah Willingham	Vice President, Product Support Services
John G. Connors	Corporate Controller
Christopher R. Gibbons	Chief Information Officer
Gregory B. Maffei	Treasurer

Corporate Headquarters
Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399
USA

European Headquarters
Microsoft Europe
Tour Pacific
Cedex 77
92977 Paris-La Defense
FRANCE

Latin American Headquarters
Microsoft Latin America
Cambridge Executive Center
899 West Cypress Creek Road
Suite #400
Ft. Lauderdale, FL 33309
USA

Manufacturing
Microsoft Corporation
Manufacturing and Distribution
Center at Canyon Park
21919 20th Avenue SE
Bothell, WA 98021
USA

Microsoft Manufacturing B.V.
Blackthorn Road
Sandyford Industrial Estates
Dublin 18
IRELAND

Microsoft Puerto Rico, Inc.
Humacao Industrial Park
Road 3, KM 77.0 vice 77.8
Humacao 00661
PUERTO RICO

International Operations
Microsoft de Argentina S.A.
Buenos Aires ARGENTINA

Microsoft Pty.
Sydney AUSTRALIA

Microsoft Gesellschaft m.b.H.
Vienna AUSTRIA

Microsoft NV
Brussels BELGIUM

Microsoft Informatica Ltda
Sao Paulo BRAZIL

Microsoft Canada Inc.
Toronto CANADA

Microsoft Chile S.A.
Santiago CHILE

Microsoft Colombia, Inc.
Bogota COLOMBIA

Microsoft s.r.o.
Prague CZECH REPUBLIC

Microsoft Danmark ApS
Hedenhusene DENMARK

CorporaciónMicrosoft del Ecuador
Quito ECUADOR

Microsoft OY
Helsinki FINLAND

Microsoft S.A.R.L.
Paris FRANCE

Microsoft GmbH
Munich GERMANY

Microsoft Hellas SA
Athens GREECE

Microsoft Hong Kong Limited
HONG KONG

Microsoft Kft
Budapest HUNGARY

Microsoft Corporation (India) Private
Limited
New Delhi INDIA

Microsoft Israel LTD.
Tel Aviv ISRAEL

Microsoft S.p.A.
Milan ITALY

Microsoft Company Limited
Tokyo JAPAN

Microsoft CH
Seoul KOREA

Microsoft Malaysia Sdn Bhd
Kuala Lumpur MALAYSIA

Microsoft Mexico, S.A. de C.V.
Mexico City MEXICO

Microsoft Maroc
Casablanca MOROCCO

Microsoft BV
Hoofddorp NETHERLANDS

Microsoft New Zealand Ltd.
Auckland NEW ZEALAND

Microsoft Norge AS
Oslo NORWAY

Microsoft Corporation-
Beijing Representative Office
Beijing, China
THE PEOPLE'S REPUBLIC OF CHINA

Microsoft Perú S.A.
Lima PERU

Microsoft sp. z.o.o.
Warsaw POLAND

Microsoft Software Para
Microcomputadores, Lda
Lisbon PORTUGAL

Microsoft Caribbean, Inc.
Guaynabo PUERTO RICO

Microsoft Taiwan Corporation
Taipei, Taiwan
REPUBLIC OF CHINA

Microsoft AO
Moscow RUSSIA

Microsoft Singapore Pte Ltd
SINGAPORE

SOFTIMAGE, Inc.
Montreal CANADA

Microsoft (S.A.)(Proprietary) Limited
Johannesburg SOUTH AFRICA

Microsoft Iberica, S.R.L.
Madrid SPAIN

Microsoft Aktiebolag
Stockholm SWEDEN

Microsoft AG
Zurich SWITZERLAND

Microsoft (Thailand) Limited
Bangkok THAILAND

Microsoft Bilgisayar Yazilim Hizmetleri
Instanbul TURKEY

Microsoft Corporation (Dubai Branch)
Dubai UNITED ARAB EMIRATES

Microsoft Ltd
Berkshire UNITED KINGDOM

Corporation MS 90 de Venezuela, S.A.
Caracas VENEZUELA

Annual Meeting

The Annual Meeting of Stockholders will be held on Friday, October 28, 1994, at 8:00 A.M., at the Hyatt Regency Bellevue at Bellevue Place, 900 Bellevue Way NE, Bellevue, Washington.

Form 10-K

Copies of Microsoft's Annual Report on Form 10-K are available upon written request from the Investor Relations Department, Microsoft Corporation, One Microsoft Way, Redmond, Washington 98052-6399. Internet users can access copies of this annual report and other financial materials at ftp.microsoft.com in the directory MSFT.

Common Stock

Microsoft common stock is traded over the counter on the Nasdaq National Market System (MSFT).

Independent Auditors

Deloitte & Touche, Seattle, Washington

Legal Counsel

Preston Gates & Ellis, Seattle, Washington

Transfer Agent

First Interstate Bank, 26610 West Agoura Road, Calabasas, California 91302

Shareholder Inquiries

To notify Microsoft of address changes or lost certificates, shareholders can call First Interstate Bank toll-free at (800) 522-6645.

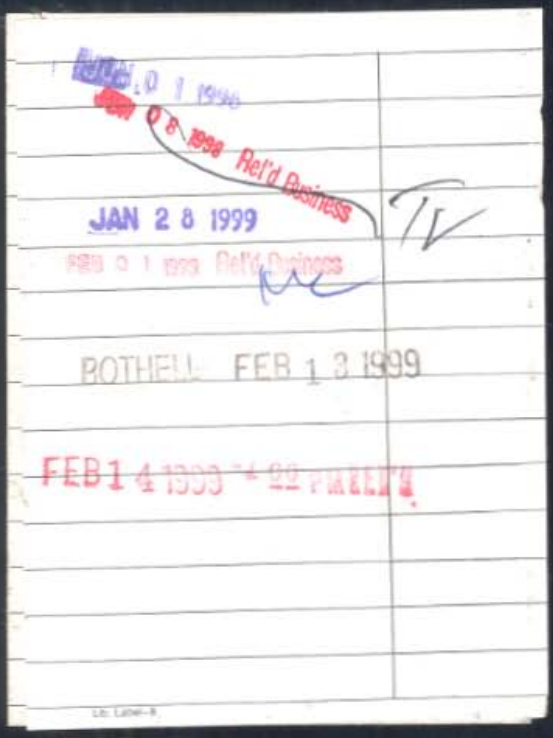
Shareholders of record who receive more than one copy of this annual report can contact First Interstate Bank and arrange to have their accounts consolidated. Shareholders who own Microsoft stock through a brokerage can contact their broker to request consolidation of their accounts.

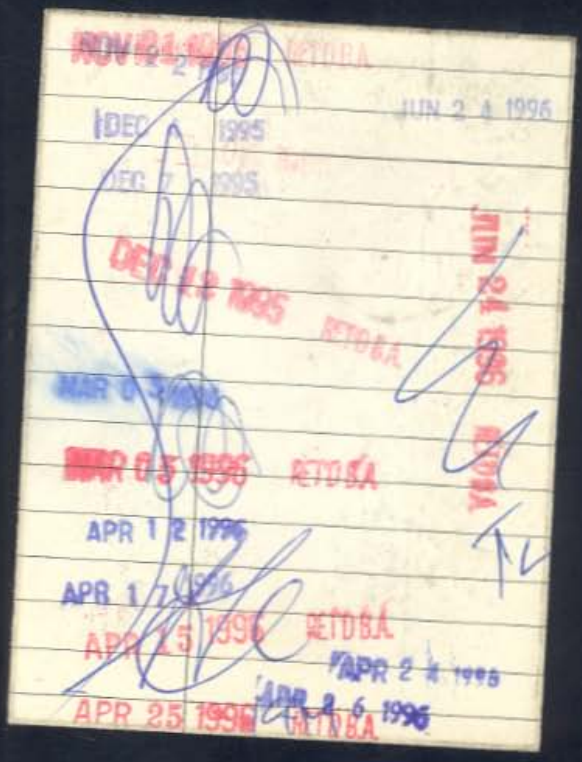
For a list of complete subsidiary addresses, please contact Microsoft Investor Relations.

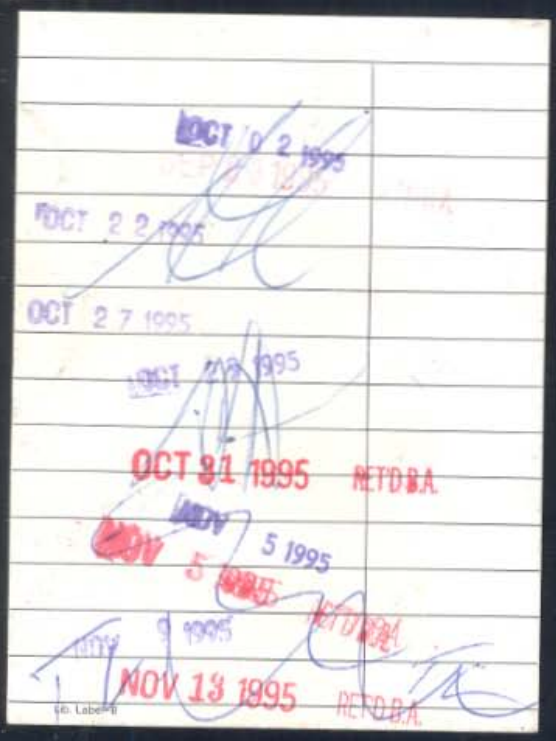
Microsoft is committed to using our own products in the workplace, and we view this technology as an essential element in the success of our Company. A variety of Microsoft products were used in the development of this annual report, including Microsoft Word, Microsoft Excel, and Microsoft Encarta.

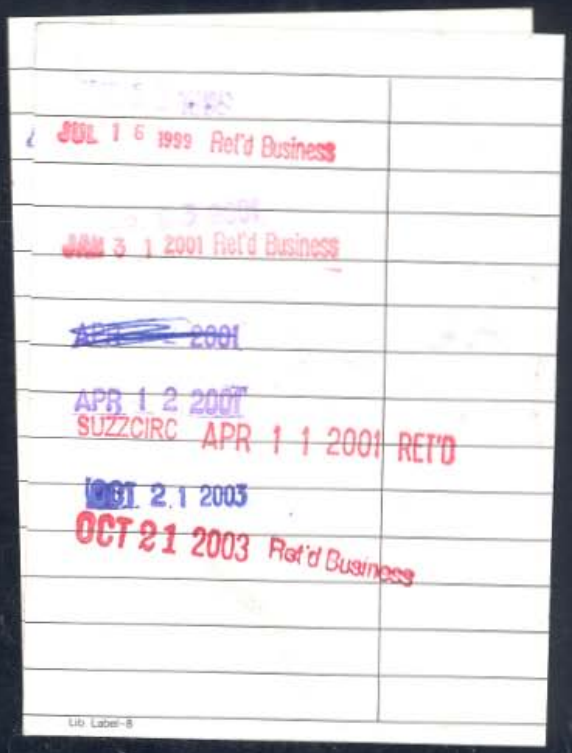
Companies, names, and/or data used in screens are fictitious unless otherwise noted.

Microsoft Corporation
One Microsoft Way
Redmond, WA 98052-6399
USA









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